L. R. B. & M. JOURNAL

VOLUME 24 NUMBER 3

JUNE, 1943

Current Tax Payment Act of 1943

Section 722 Relief Claims

Implications of Recent Supreme Court Decisions on Stock Dividends

Published by

LYBRAND, ROSS BROS. & MONTGOMERY

Accountants and Auditors

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L. R. B. & M. JOURNAL

VOLUME TWENTY-FOUR | JUNE, 1943 | NUMBER THREE

Current Tax Payment Act of 1943

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(New York Office)

The Current Tax Payment Act of 1943 became law on June 9th.

The progress of the legislation through Congress evoked unusual public interest. The controversy over its tax abatement features received such publicity that the name of one of the tax abatement proposals, the so-called Ruml Plan, became almost a household term.

The Current Tax Payment Act of 1943 is unique among recent amendments to the income tax laws. It is the first revenue act since the Revenue Act of 1918 that changes the time of payment of the tax by resident individuals.

For the purposes of this article, the discussion of the provisions of the act has been divided into three parts. Part I deals with the provisions for the current payment of the income tax; Part II discusses the tax abatement provisions; Part III is devoted to certain miscellaneous provisions contained in the act.

Part I

The provisions of the act placing resident taxpayers on a current pay-as-you-go basis effect no changes in the time for payment of a corporation's income tax, or of the income tax of an estate or trust. The income tax of such taxpayers continues to become due and payable on the fifteenth day of the third month following the close of the taxable year, or they may elect to pay in four equal instalments due respectively on the fifteenth day of the third, sixth, ninth and twelfth months following the close of the taxable year.

Two new methods are provided for the current payment of the income tax by resident individuals. These methods differ radically from each other. One consists of the withholding of tax by employers from salaries and wages paid, and the other calls for a current estimate and payment of the tax by the taxpayer where his income is expected to exceed certain stipulated annual amounts.

SALARIES AND WAGES

Section 2 of the act, by adding subchapters D and E to Chapter 9 of the Internal Revenue Code, provides for the collection of the income tax at the source on salaries and wages. Chapter 9, which is entitled "Employment Taxes," imposes the social security taxes.

The definition of taxable salaries and wages contained in new subchapter D as it applies to salaries and wages paid by private employers is substantially the same as that prescribed for social security tax purposes. Salaries and wages paid by governmental employers, which are generally exempt from social security taxes, are subject to the withholding requirements of the Current Tax Payment Act of 1943, except that compensation paid to members of the armed forces of the United States is exempt from withholding.

Subchapter D applies to all employers that pay salaries and wages as therein defined regardless of the number of employees which the employer may have.

Employers subject to the provisions of subchapter D are required to withhold from each payment of salaries and wages a tax equal to the *greater* of the following:

(1) 20 per cent of the excess of such payment over the family status withholding exemption; or

(2) 3 per cent of the excess of such payment over the Victory tax withholding exemption.

The *family status withholding exemption*, where the pay roll period is a period of one year, is as follows:

Single person	$ 624
Married person living with husband or wife, or head of of family	1,248
Each dependent, other than first dependent in the case of the head of a family	312

Where the pay roll period is a shorter period, e.g., semimonthly or weekly, the family status exemption allowable in each pay roll period is correspondingly reduced.

Where both husband and wife receive salaries or wages, either one may elect to claim the whole exemption, otherwise it must be divided *equally* between them.

The employer determines the exemption status of each employee from exemption certificates to be obtained from the employees.

The *Victory tax withholding exemption* is that which has been used since January 1, 1943 in determining the amount to be withheld on account of the Victory tax, viz., $624 where the pay roll period is a period of a year, with no additional exemption because of marital status or dependents. Where the pay roll period is shorter than a year, the Victory tax withholding exemption allowable in each pay roll period is correspondingly reduced.

Alternative tax (1) will be the greater in the case of taxpayers subject to both the income tax and the Victory tax. Alternative tax (2) will be the greater in the case of taxpayers subject to the Victory tax but not subject to the income tax, or whose net income is only slightly in excess of the family status withholding exemption to which they are entitled.

In order to facilitate the computation of amounts to be withheld

the employer is granted the privilege of using wage bracket withholding tables contained in the act, similar in nature to the withholding tables prescribed for use commencing January 1, 1943 in computing the amount to be withheld for the Victory tax. The Commissioner is given authority to permit withholding on the basis of estimated average wages during each quarter, provided the amount withheld is adjusted to the correct amount by the end of the quarter.

Employers must furnish a statement annually on or before January 31 to each employee showing the salary or wages paid and the amount of taxes deducted and withheld in respect of such employee during the preceding calendar year. In the event of a separation during the year a similar statement covering the portion of the year prior to the date of separation must accompany the final payment to the employee.

Employers are required to withhold the 5 per cent Victory tax from all payments of salaries and wages between January 1 and June 30, 1943, including payments in 1943 after June 30 in respect of a payroll period beginning on or before June 30, 1943. As to all subsequent payments, the withholding requirement is either 20 per cent or 3 per cent as heretofore outlined.

Employers are required to report and pay over to the Collectors of Internal Revenue (or to banks authorized by the Secretary of the Treasury), in accordance with the method now prescribed for the old-age benefits tax, all amounts withheld from employees for the income tax and the Victory tax.

Declaration of Estimated Tax

The rate of withholding from salaries and wages is limited to 20 per cent, which is intended to approximate the combined rate of the Victory tax (3 per cent net), the normal tax of 6 per cent and the first surtax bracket of 13 per cent. The result is that taxpayers receiving salaries or wages which put them in higher surtax brackets are rendered only partially current in their tax payments by the withholding provisions of the act. Such taxpayers are required to estimate their total tax for the current taxable year and pay during the year that part which is in excess of the amount to be withheld by their employers.

The withholding of the tax at the source in order to place the taxpayer on a pay-as-you-go basis was not applied to income other than salaries and wages, for the reason, as stated by the Senate Finance Committee, that to do so was deemed impracticable. The act therefore prescribes that taxpayers receiving income other than salaries or wages, and also salaries and wages above certain stipulated annual amounts, shall estimate their tax for the tax-

able year and pay such tax during the year.

A declaration of estimated tax must be made by all taxpayers falling within one or more of the following classifications:

(*a*) *Gross income from salary or wages:*

(1) Single or married but not living with husband or wife and reasonably expecting to receive a salary or wages in excess of $2,700 in the current taxable year or who received a salary or wages in excess of $2,700 in the preceding taxable year.

(2) Married and living with husband or wife and reasonably expecting to receive a salary or wages which, when added to that received by the husband or wife, will exceed $3,500 in the current taxable year, or who received a salary or wages in the preceding taxable year which, when added to that received by the husband or wife, exceeded $3,500.

(3) Reasonably expecting to receive a lesser amount of salary or wages for the taxable year beginning in 1943 than was received for the taxable year beginning in 1942 and for which year a return was required.

(*b*) *Gross income other than salary or wages:*

(1) Single or married but not living with husband or wife and reasonably expecting to receive more than $100 of such gross income for the current taxable year and whose total income would be such as to require the filing of a return, or who met such requirements for the preceding taxable year.

(2) Married and living with husband or wife and reasonably expecting to receive in the aggregate with husband or wife more than $100 of such gross income, and the expected total income of husband and wife combined being such as to require the filing of a return, or who met such requirements for the preceding taxable year.

A joint declaration may be filed by a husband and wife who live together. The making of a joint declaration does not preclude the filing of separate returns after the close of the taxable year.

A taxpayer's declaration must be filed with the same Collector with whom his income tax return is required to be filed. Declarations, except those made by farmers, must be filed on or before the fifteenth day of the third month of the taxable year, except that the declaration for 1943 of a taxpayer on the calendar year basis is due on September 15, 1943. With respect to a fiscal year beginning in 1943 the filing date is to be prescribed by the regulations. Amendments to the declaration filed are allowed, if filed not later than the fifteenth day of the last month of the taxable year. Declarations made by farmers must be filed on or before the fifteenth day of the last month of the taxable year.

Where the tax for 1942 is greater than the tax reasonably expected to be paid for 1943 the tax for 1942 is the amount to be declared as the estimated tax for 1943. See the discussion of *Increase* (*B*) contained in Part II of this article.

PAYMENT OF ESTIMATED TAX

One quarter of the estimated tax payable is payable with the filing of the declaration. The balance is payable in three equal instalments due respectively on the fifteenth day of the sixth, ninth and twelfth months of the taxable year. Payments made in 1943 prior to September 1, 1943, in respect of the tax liability for taxable years that commenced in 1942, are deemed to have been made on account of the tax for 1943, and decrease ratably the instalments of the estimated 1943 tax due after September 1, 1943. Thus, the payments of 1942 tax made on March 15 and June 15, 1943, by a taxpayer on the calendar year basis are applied in reduction of his estimated 1943 tax. The balance of his estimated 1943 tax (less the amount of the Victory tax withheld by his employer from salary or wages paid in 1943 other than in respect of pay roll periods beginning after June 30, and less the estimated amount, if any, that will be withheld by his employer from salary or wages paid in 1943 in respect of pay roll periods beginning after June 30) is payable in two equal instalments on September 15 and December 15, 1943.

The act imposes penalties in the form of additions to the tax in the event of failure to file the declaration as required or to pay the required instalments of the tax, and in the event of a substantial underestimate of the tax.

NO CHANGE IN INCOME TAX OR VICTORY TAX

The Current Tax Payment Act of 1943 makes no changes in the rates of the income tax or the Victory tax, nor does the act repeal existing provisions of the Code requiring the filing of a return for each taxable year on the fifteenth day of the third month following the close of the taxable year. The privilege formerly granted to taxpayers to pay the tax shown on the return in quarterly instalments has, however, been revoked. Accordingly, a taxpayer on the calendar year basis is required to file an income and Victory tax return for 1943 on or before March 15, 1944, and to pay on or before that date all of the tax shown on the return, except that payment in whole or in part of certain increases in the tax for 1943 may be deferred as outlined in Part II of this article. The amount of tax shown on the return will be credited with the amount withheld from the salary or wages paid to him in 1943, and with the estimated tax paid by him in 1943 on the basis of the declaration of

estimated tax filed by him. Where the amount withheld and the payments of estimated tax were excessive, refunds *by Collectors* are authorized where the refund does not exceed $1,000.

Part II

It has been stated in this article that the act makes any payments in 1943 prior to September 1 (which had been made on account of the income tax for 1942 and through withholding of the Victory tax for the first half of 1943) apply in reduction of the liability for 1943, thus putting taxpayers immediately on at least a partial pay-as-you-go basis with respect to the current year's tax.

Use of the device of applying payments of the 1942 tax to reduce the liability for the 1943 tax posed the question of how to dispose of the 1942 liability. Some form of relief had to be granted if the hardship of double payments in 1943 were to be avoided. Such relief could take one of two forms. It could permit either (a) the abatement of the 1942 tax or (b) an extension of the time when it would become due, with instalment payments provided for over a long period of time in order to mitigate the hardship of double payments.

The "relief" granted by the Current Tax Payment Act of 1943 is a compromise embodying both abatement of tax, in whole or in part, and extension of time.

ABATEMENT

The act abates or discharges in full as of September 1, 1943 the tax for taxable years that began in 1942 (referred to as taxable year 1942). However, to offset partially such abatement the act makes certain increases in the tax for taxable years that begin in 1943 (referred to as taxable year 1943). For discussion purposes they will be referred to as Increase (A), Increase (B), Increase (C) and Increase (D), respectively, in this article. A taxpayer may be subject to both Increases (A) and (C) or to both Increases (B) and (D). Illustrative computations of these types of increases are contained in an appendix to this article.

Increase (*A*) results when the tax for 1942 is not greater than the tax for 1943. In that event the tax for 1943 is increased by 25 per cent of the tax for 1942, except that where the tax for 1942 was $50 or less the taxpayer is not subject to Increase (A). The act contains a notch provision so that Increase (A) in the case of taxpayers having a tax for 1942 slightly in excess of $50 is 25 per cent of the 1942 tax, or (notch provision) the excess of the tax for 1942 over $50, whichever is the lesser.

Increase (*B*) results when the tax for 1942 is greater than the tax for 1943. In that event the tax for 1943 is increased by:

(1) the excess of the tax for 1942 over the tax for 1943, plus

(2) if the tax for 1943 is more than $50, 25 per cent of the tax for 1943, or (notch provision) the excess of the tax for 1943 over $50, whichever is the lesser. No. (2) is limited, however, so as not to exceed 25 per cent of the tax for 1942, or (notch provision) the excess of the tax for 1942 over $50, whichever is the lesser. The Conference report indicates that this limitation is designed to reach some special situations, particularly where large amounts of tax-free covenant bonds are held. Increase (B) (1) differs from Increase (A), Increase (B) (2), Increase (C) and Increase (D), in that it *is* a part of the estimated tax for 1943 which is due within the taxable year 1943.

Increase (*C*) results when there is increased income as compared with prewar income, and the tax for 1942 is not greater than the tax for 1943. In that event the tax for 1943 is increased by the excess, if any, of 75 per cent of the tax for 1942 over a tentative tax computed at 1942 rates as though the surtax net income for the base year plus $20,000 constituted both the surtax net income and the net income for the taxable year 1942 after allowance of all credits against net income.

Increase (*D*) results when there is increased income as compared with prewar income and the tax for 1942 is greater than the tax for 1943. In that event the tax for 1943 is increased by the excess, if any, of 75 per cent of the tax for 1943 over a tentative tax computed at 1943 rates (including the Victory tax) as though the surtax net income for the base year plus $20,000 constituted both the surtax net income and the net income for the taxable year 1943 after allowance of all credits against net income.

For purposes of computing Increase (C) and Increase (D) the base year is whichever of the taxable years that began in 1937, 1938, 1939 and 1940 the taxpayer may select.

How to compute Increase (C) and Increase (D) where capital gains were realized in the base year, the taxable year 1942 or the taxable year 1943 is left by the act to be prescribed by regulation, as is the computation of the tentative Victory tax under Increase (D).

Relief Provisions

(1) If a taxpayer is subject to Increase (C) or Increase (D) and his income for the taxable year 1942 or 1943 includes compensation for services rendered over a period of thirty-six months or more, a portion of which is attributable under section 107 of the Code to the base year, such portion is excluded from his income for 1942 or 1943 and included in his income for the base year.

(2) If a taxpayer is subject to Increase (C) or Increase (D) and during his base year was a stockholder in a corporation which was completely liquidated prior to May 1, 1943 and its business thereafter continued by the taxpayer as a sole proprietorship or a partnership, such taxpayer may compute his income for the base year as though all of the earnings and profits of the corporation for its taxable year ending with or within the base year had been distributed as dividends. If his proportionate interest in the partnership is less than that in the corporation his distributive share of the corporation's earnings and profits must be reduced to conform to his proportionate interest in the partnership.

(3) If the taxpayer is in active service in the armed forces of the United Nations at any time during the taxable year 1942 or 1943 and is subject to Increase (B) (1) such increase is reduced by the amount by which the 1942 tax is increased through the inclusion in income for that year of earned net income (as defined in section 25 (a) (4) of the Code for purposes of computing the earned income credit).

(4) If the taxpayer is subject to Increase (A) or Increase (B) (2) the full amount of such increase is due on the fifteenth day of the third month following the close of the taxable year 1943, which is March 15, 1944 for taxpayers on the calendar year basis. Such increases, unlike Increase (B) (1) are *not* a part of the estimated tax for 1943 which is due within the taxable year 1943. The taxpayer may however obtain an extension of time to the fifteenth day of the fifteenth month following the close of the taxable year 1943 within which to pay one-half of such increases without interest. For taxpayers on the calendar year basis such extended due date is March 15, 1945.

(5) If the taxpayer is subject to Increase (C) or Increase (D) the full amount of such increase is due on the fifteenth day of the third month following the close of the taxable year 1943, which is March 15, 1944 for taxpayers on the calendar year basis. Such increase is *not* a part of the estimated tax for 1943 which is due within the taxable year 1943. The taxpayer may elect to pay such increase in four equal instalments with interest at the rate of 4 per cent per annum on each instalment. The first instalment is due on the fifteenth day of the fifteenth month following the close of the taxable year 1943, which is March 15, 1945 for taxpayers on the calendar year basis. The remaining three instalments are due annually thereafter.

Joint Returns

If husband and wife made a joint return for either the taxable year 1942 or 1943, their incomes are to

be aggregated for purposes of determining whether they are subject to Increase (A), Increase (B), Increase (C) or Increase (D) and, if so, in computing the amount thereof.

DEATH

If the taxpayer died in 1942, no part of the tax for 1942 is discharged.

If he dies in 1943, the tax for 1943 is computed in the same manner as for a living taxpayer.

Part III

The Current Tax Payment Act of 1943 makes certain important amendments to the Internal Revenue Code which are unrelated to the provisions placing resident individuals on a pay-as-you-go basis.

The act amends section 22 (b) (13) of the Code to give a taxpayer in active service in the armed forces of the United Nations the right to exclude from gross income so much of the compensation received for such service as does not exceed $1,500 in the taxable year. The amendment is effective beginning with taxable years beginning in 1943.

The act adds Supplement U to subchapter C of Chapter 1 of the Code, which provides that if a taxpayer dies on or after December 7, 1941 while in active service in the armed forces of the United Nations there is no liability for income tax (including Victory tax) with respect to the taxable year in which he died. It also provides for the abatement of all income taxes (including Victory tax) for preceding taxable years unpaid at the date of death and for the refund or credit of any such taxes that were paid by his estate.

The act amends section 3770 of the Code (relating to authority to make credits and refunds) and section 3790 (prohibiting administrative review of the Commissioner's decisions) to provide that interest on tax refunds or credits shall not be denied because it is finally determined that there was no tax liability and that the allowance or nonallowance by the Commissioner of interest on such refunds or credits shall not be subject to review by any administrative agency of the United States other than the Tax Court. Thereby is put to rest the uncertainty engendered by the ruling of the Comptroller General (C. G. O. B-23415) disallowing interest on a tax refund on the ground that there was no overpayment since there was no liability to pay any tax.

The act extends to March 1, 1944 the time during which powers of appointment may be released without being deemed, for purposes of the estate and gift taxes, a transfer of property by the releasor.

APPENDIX

1. Illustrative Computation of *Increases (A) and (C)* for a single person, without dependents, on the calendar year basis, with the following net income:

Base Period Years	*Surtax Net Income*		1942	1943
1937	$10,000	Normal tax net income	$48,000	$50,500
1938	8,000	Surtax net income	50,000	52,500
1939	9,000	Victory tax net income	......	55,000
1940	12,000			

Tax on 1943 income:

Normal tax and surtax		$27,920	
Victory tax (assuming maximum credit of $500 against the tax)		2,250	
Total tax on 1943 income		$30,170	(1)

Increase (A)—25 per cent of tax on 1942 income:

Normal tax and surtax on 1942 income	$26,120		
25 per cent thereof		$ 6,530	(2)

Increase (C)—comparison with base year:

75 per cent of tax on 1942 income		$19,590	
Less, Tentative tax computed at 1942 rates on surtax net income of base period year (to be selected by taxpayer from years 1937-1940) plus $20,000:			
Surtax net income for 1940 (highest base period year)	$12,000		
Allowable increase	20,000		
	$32,000		
Normal tax and surtax on $32,000		14,240	
Increase (C)		$ 5,350	(3)

Total tax for 1943:

(1) Normal tax, surtax and Victory tax	$30,170*
(2) Increase (A)	6,530†
(3) Increase (C)	5,350‡
Total	$42,050

*To be declared and paid (through amounts withheld at source and by direct payments, including amounts paid on account of 1942 taxes) during 1943.

†Payable March 15, 1944, or at election of taxpayer payment of one-half may be deferred to March 15, 1945, without interest.

‡Payable March 15, 1944, or at election of taxpayer in four equal annual instalments, with interest from March 15, 1944, at the rate of 4 per cent per annum on each instalment, the first instalment being due on March 15, 1945.

2. Illustrative Computation of *Increases* (*B*)(*1*), (*B*)(*2*) *and* (*D*) based upon the same assumptions as the preceding computation except that normal tax net income, surtax net income, and Victory tax net income for 1943 are reduced to $38,000, $40,000 and $42,500, respectively.

Increase (B)(1)—excess of 1942 tax over 1943 tax:

Normal tax and surtax on 1942 income		$26,120	
Tax on 1943 income:			
Normal tax and surtax	$19,300		
Victory tax (assuming maximum credit of $500 against the tax)	1,625	20,925	(1)
Increase (B)(1)		$ 5,195	(2)

Increase (B)(2)—25 per cent of tax on 1943 income:

Tax on 1943 income	$20,925		
25 per cent thereof		$ 5,231	(3)

Increase (D)—comparison with base year:

75 per cent of tax on 1943 income		$15,694	
Less, Tentative tax computed at 1943 rates on surtax net income of base period year (to be selected by taxpayer from years 1937-1940) plus $20,000:			
Surtax net income for 1940 (highest base period year)	$12,000		
Allowable increase	20,000		
	$32,000		
Normal tax and surtax on $32,000	$14,240		
Victory tax (assuming Victory tax net income of $34,000 and maximum credit of $425 against the tax) (see note below)	1,275	15,515	
Increase (D)		$ 179	(4)

Note: The Act does not indicate how the Victory tax should be applied in such a computation. The Conference report recognizes the problem but states (page 62) "compute a tentative Victory tax based on an amount determined by a ratio based upon relationships with respect to the types of 1943 incomes." The formula for application of the Victory tax must therefore await issuance of the regulations.

In the above computation the Victory tax net income ($42,500) is 17/16th of the surtax net income ($40,000) for 1943, and for the present purpose that ratio has been applied to the constructive surtax net income of $32,000 to produce a constructive Victory tax net income of $34,000. However, this method is not necessarily the one the Commissioner may require to be used.

Total tax for 1943:

(1) Normal tax, surtax and Victory tax	$20,925*
(2) Increase (B)(1)	5,195*
(3) Increase (B)(2)	5,231†
(4) Increase (D)	179‡
Total	$31,530

*To be declared and paid (through amounts withheld at source and by direct payments, including amounts paid on account of 1942 taxes) during 1943.

†Payable March 15, 1944, or at election of taxpayer, payment of one-half may be deferred to March 15, 1945, without interest.

‡Payable March 15, 1944, or at election of taxpayer, in four equal annual instalments, with interest from March 15, 1944 at the rate of 4 per cent per annum on each instalment, the first instalment being due on March 15, 1945.

Claims for Relief Under Section 722 of the Excess Profits Tax Law*

BY JOHN MCCULLOUGH
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Before considering the detailed problems of preparing claims for relief under a general section of the Internal Revenue Code, such as section 722, the controller or tax practitioner should satisfy himself that all other specific methods of obtaining relief or exemption from the excess profits tax have been exhausted.

This study would involve a review of section 725, relating to personal service corporations; section 726, relating to corporations completing contracts under the Merchant Marine Act, 1936; section 727, relating to exempt corporations, which include, among others, personal holding corporations; section 730, relating to consolidated returns; section 731, relating to corporations engaged in mining of strategic metals; section 735, relating to non-taxable income from certain mining and timber operations; and section 736, relating to relief for instalment basis taxpayers and taxpayers with income from long-term contracts. The provisions of Supplement A, which permit under certain conditions the addition of the base period earnings of predecessor organizations, whether such predecessors were corporations, partnerships or individuals, should not be overlooked.

Where corporations are affiliated or owned by substantially the same interests, study should be made of the possibilities involved in mergers, consolidations and liquidations. Transfers of part of the assets of one corporation to another should also be considered. Occasionally, it is feasible to effect a transfer of income producing property, not used in ordinary operations, to the stockholders. The collection and distribution of income in such cases may be left to an agent acting under a limited power of attorney. Some thought should be given in the case of smaller corporations to the question of their dissolution. Incidentally, the sharp increase in corporate income and excess profits tax rates makes it advisable to review agreements relating to trusts, syndicates, joint ventures, partnerships and even powers of attorney in order to avoid the possible contention that the group should be taxed as an association.

*Based on an address prepared for the meeting of the Controllers Institute of America, held in Cleveland, Ohio, on May 10, 1943.

Importance of Section 722

Section 722 not only places serious responsibilities upon the controller and the tax practitioner but also presents them with unusual opportunities. The responsibilities are serious because the tax involved is nearly always substantial and, in many cases, is so large that the outcome of the case may have a material bearing on the future course of the taxpayer. Where the taxpayer is subject to the 90 per cent rate and the net income exceeds $50,000, an increase of $1.00 in the excess profits credit will effect the following reduction in total income and excess profits taxes:

Year	*Reduction*
1940	25¢ to 50¢
1941	24¢ to 41¢
1942	41¢

Such reduction in taxes results in a direct credit to the surplus of the taxpayer, and is to be contrasted with other increments to income which result in only fractional credits to surplus due to the imposition of high rates of taxation.

Section 722 presents an unusual opportunity for the full expression of the ingenuity, resourcefulness and knowledge of both the controller and the tax practitioner. The determination of the constructive average base period net income will call in most cases for the application of accounting skill of the highest order and in many cases for a thorough knowledge of economics. In fact, it has been said that economists were employed to assist in the drafting of the general relief sections and that they may be employed by the Bureau to assist in the disposition of cases in which the benefit of those sections is claimed.

Importance of the Controller

The presentation of a tax case before the Bureau and its ultimate prosecution before the courts usually involves a fairly detailed statement of facts, nearly always of an accounting nature. It is generally recognized by the practitioners that the effectiveness of the presentation of the cases is very definitely enhanced by the active collaboration of the controller. Many a case has been won because the controller was able to recall certain facts and to make a forceful presentation of them. This proposition will be particularly true in cases involving the application of section 722. The tax practitioner will have to lean heavily on the management because most cases will probably require, first, an estimate of the volume of sales, second, an estimate of the cost of such sales and, third, an estimate of the operating expenses.

Detailed Comparative Income Account

Every taxpayer in existence before January, 1940, should prepare as a basic statement a detailed comparative income account for each year beginning with 1933 or 1934

and ending with the current taxable year. The net income or loss should be reconciled with net income or loss as finally adjusted or approved by the Treasury Department. This statement should be departmental and contain as much detail as feasible. From this basic statement, there should be prepared a statement accounting for the variation in gross profit and also a statement of comparative costs. Finally, a comparison should be made of the operating expenses and other deductions and, from this comparison, there should be prepared a statement showing the material variations in the expenses or other deductions. Frequently, the management finds this basic data illuminating and rather effective for discovering abnormalities which may be otherwise overlooked or forgotten.

With this basic data before him, the controller or tax practitioner should be able to account for or to determine the factors which produced the excess profits. If the excess profits are due solely to the expanded demand or other factors arising from the improvement in economic conditions or events in the current taxable year as compared with the base period years, the taxpayer has no claim for relief and the controller or tax practitioner may be satisfied that his responsibility has been discharged. However, if the excess profits are due to other factors, pains should be taken to determine whether the basic data assembled, discloses bases for relief under one of the other relief sections. For example, an unusually large item of income in the current taxable year may be found to be partly the cause. Relief may be found in section 721 or in section 736, if the gross income has increased and the taxpayer reports on the instalment basis or has income from long-term contracts. On the other hand, the analysis may indicate that the excess profits are due in part to abnormal deductions in the base period. Relief may be available in section 711(b)(1)(J). Finally, the analysis may indicate that the excess profits are due to the fact that the gross income during the base period has been depressed below a figure which represents the normal earnings of the taxpayer during the base period. If such is the case, the taxpayer may have a basis for filing a claim under section 722(b).

There is no point, however, in spending any time on an abnormality which has adversely affected a year which is eliminated under the so-called 75 per cent rule unless the adjustment is so large that the reconstructed income for the year shall exceed 75 per cent of the average of the other three years. There is no point in filing the claim if the taxpayer is enjoying the benefits of the growing income method if the abnormality relates to either

or both of the first two years and is not sufficiently large to make the general average method applicable. Again, there is no point in filing a claim if the abnormality is completely offset by an abnormally large item of income or an abnormally small deduction in some other year of the base period. Section 722, prior to its amendment by the 1942 Act, specifically required the adjustment of the base period years for abnormally large items of income or abnormally small deductions. Section 722, as amended, inferentially continues the same requirement since subsection 722(a) requires the taxpayer to establish "what would be a fair and just amount representing normal earnings". Section 30.722-2(b)(2), Reg. 109, just promulgated, specifically requires that above-normal earnings in other years of the base period be adjusted.

Finally, no claim even for 1940 and 1941 should be filed without giving consideration to the so-called 80 per cent rule, a peculiar situation created by section 710(a)(1)(B) which limits the sum of the normal tax, surtax and excess profits tax to 80 per cent of the surtax net income computed without regard to the credit for income subject to the excess profits tax.

Effect of 80 Per Cent Rule

This rule creates a peculiar situation because, within certain limits, an increase in the excess profits credit results in a net increase in the tax after deducting the post-war refund. As the excess profits credit increases, the excess profits tax and the post-war refund decrease although the total tax payable remains the same. There is therefore no point in filing a claim unless the adjustment is large enough to make the 80 per cent rule inapplicable. When the net income is in excess of $50,000 and the normal tax net income, surtax net income (disregarding the credit for income subject to the excess profits tax) and excess profits net income are all the same, it will be found that the adjustment must exceed 21.951 per cent of the excess of the net income over 5 times the sum of the specific exemption, the excess profits credit and the unused excess profits credit adjustment.

This peculiar situation creates several problems. Assume that the taxpayer has a basis for filing claims for 1940 or 1941 or both years but that the refunds are less than the reduction in the post-war refund for 1942, arising from the carry-over of the unused credits. If the taxpayer has filed the claims and accepted the refunds for 1940 and 1941, it is probable that it will have to suffer the reduction in the post-war refund for 1942. On the other hand, if it has not filed the claims or if it has not accepted the refunds, it may not be in a position to determine the advisability of its course of action by September 15th since

the effects of renegotiation and the unused excess profits credit carry back to 1942 may or may not take that year out of the 80 per cent rule. The taxpayer faces the same question with respect to the advisability of filing a claim for 1942 irrespective of the situation with regard to 1940 and 1941. This problem is now under consideration and it is possible that some satisfactory solution may be worked out with the Commissioner before September 15th. It is generally agreed that contingent claims for refund are of no validity. It has been suggested that it may be advisable to file a claim setting forth the ground for relief but omitting the computation of the claim until such time as the effects of renegotiation are known. The new regulations are silent with respect to this problem. However, they do require that detailed information supporting the constructive average base period net income be submitted within a reasonable length of time after the due date of the claim.

Incidentally, section 30.722-5(a) (1) of the new regulations provides that, for the purpose of the carry-over from 1940 to 1941, it will suffice if a taxpayer files a claim which is timely with respect to the year to which the carry-over is to be made.

Content of Form 991

The new regulation states that:

Except as otherwise provided in this section, the application for relief shall set forth in detail and under oath each ground under section 722 upon which the claim for relief is based, and facts sufficient to apprise the Commissioner of the exact basis thereof. The mere statement of the provision or provisions of law under section 722 upon which the claim for relief is based shall not constitute an application for relief within the meaning of section 722. If a claim for relief is based upon section 722(b)(5) and paragraph 30.722-3(e) (relating to factors other than those expressly provided by section 722(b)(1), (2), (3), and (4) and paragraph 30.722-3(a), (b), (c), and (d)), the application must state the factors which affect the business of the taxpayer, which may reasonably be considered as resulting in an inadequate standard of normal earnings during the base period and the reasons why the extension of relief under section 722 to the taxpayer would not be inconsistent with the principles underlying the provisions of section 722(b)(1), (2), (3), and (4) and paragraph 30.722-3(a), (b), (c), and (d), and with the conditions and limitations enumerated therein.

If it is not possible for the taxpayer prior to September 16, 1943, to obtain, prepare and present all the detailed information required to establish its eligibility for relief and the amount of its constructive average base period net income, such information may be submitted within a reasonable time after filing the application as a supplement to the application. No new grounds presented by the taxpayer after September 15, 1943, will be considered in determining eligibility for relief or the amount of the constructive average base period net income to be used in computing such relief for taxable years beginning in 1940 or 1941.

Probably the most important factor in the preparation of Form 991 is the inclusion of a complete explanation of *all* the factors which the taxpayer has claimed as causes for a depressed average base period

net income. While no new grounds may be added to the claim, the taxpayer can probably supplement or amend the computation of the average normal earnings after the lapse of the due date for the filing of the claim. Furthermore, as in the case of ordinary claims for refund, the taxpayer may after filing the claim submit additional proof or evidence in support of its contentions.

General Rules for Determination of Constructive Income

The new regulations make it plain that the constructive income must reflect normal earnings and that section 722 must not be employed for the purpose of obtaining unfair advantage. Thus, they provide that, in reconstructing the income, the taxpayer is not entitled as a matter of right to the growing income method or to the so-called 75 per cent rule. For example, section 722(b)(3)(B) contemplates that relief shall be granted where the base period years fail to reflect adequately years of high profits. A taxpayer would not be permitted to assume arbitrarily that the latter half of the base period should be adjusted to reflect the higher profits so that the growing income method should also be available. However, these methods are available in proper cases and should be employed to avoid discrimination. The same proposition applies with respect to the adjustment for abnormal deductions provided by section 711(b)(1)(H), (I), (J), and (K).

Section 736(a) relating to instalment basis taxpayers and section 736(b) relating to taxpayers with long-term contracts require that the former taxpayers shall not change their method of accounting during the base period to the accrual basis and conversely that the latter taxpayers shall recompute their income during the base period to reflect the long-term method of accounting. The new regulations state that section 722 shall not be used as a means for avoiding the operation of sections 736(a) and 736(b).

Abnormality Due to Interruption of Production Becau se of Unusual Events

The first ground for relief applicable to taxpayers incorporated prior to January 1, 1940, is found in subsection 722(b)(1) and provides relief for those cases where normal production in one or more of the taxable years in the base period was interrupted because of unusual events which occurred immediately prior to or during the base period. Item 1, Schedule B, on page 3 of Form 991 fails to bring out the important point that the event may have occurred immediately prior to the base period. The form requires, (a) a description of the events and time of occurrence and (b) a statement of the taxable years in the base period under which normal

operations were adversely affected. Item 6 on page 5 of the form requires that a profit and loss statement and supporting schedules reconstructed in detail for each year be attached to the form. The Senate Finance Committee report indicates that subsection (1) is concerned primarily with physical rather than economic events. The new regulations cite floods, fires, explosions and strikes as examples.

The taxpayer is entitled to relief under this section so long as a strike is the proximate cause of the abnormality. The strike need not, therefore, occur in the taxpayer's plant. The production may have been interrupted because of a strike in the plant of some concern with which the taxpayer did not even do business.

In several instances the Treasury has already disallowed claims filed under this subsection on the ground that the taxpayer failed to show that it suffered a direct loss in earnings. The Treasury argues that it is not sufficient to show by comparative statistics that the volume of sales in the particular year was lower than the alleged normal amount although the new regulations indicate that such statistics may be used to determine normal earnings. The examining agents argued that the strike merely had the effect of postponing the dates of delivery and that in fact no sales were actually lost. In some instances this argument may be difficult or impossible to refute, particularly where the abnormal event was only of a temporary nature. The question should be thoroughly discussed with the sales department or the officer in charge of sales and all available proof should be obtained and submitted in support of the claim. It may be well to correspond with distributors and dealers, and possibly customers, to show samples of instances where actual sales were lost. A study of the unfilled orders at the date of the strike and the ultimate disposition of such orders may be helpful.

The Treasury has allowed abnormal deductions due to a strike in its adjustments under section 711 (b)(1)(J). In reconstructing the income for any particular year care should be exercised to make sure that the cost of the increased volume of sales is correctly computed. Examining agents in several instances have indicated a tendency to overlook the fact that certain costs and expenses are fixed and that an increase in volume has no effect on them.

The taxpayer should claim an abnormality under subsection 1 if it suffered from slowdown strikes which were more or less prevalent throughout the base period years. The effect of these strikes is rather apparent as it can readily be discovered from a study of comparative labor costs. In some instances the increase will be readily apparent by inspection.

Abnormality Because of Temporary Economic Circumstances

Subsection 722(b)(2) provides relief in those cases where the business of the taxpayer was depressed in the base period because of temporary economic circumstances unusual in the case of the taxpayer or of the industry of which the taxpayer was a member. The Senate Finance Committee report and the new regulations state that this subsection covers the loss of the sole customer with whom the taxpayer has done business for a number of years. Another example given is the case of a price war which adversely affected the operations of the industry of which the taxpayer was a member during the base period.

Form 991 requires a description of the temporary economic events, and where the industry was affected, the taxpayer is required to describe the industry and to furnish names and addresses of other members. The form also requires a schedule showing the computation of the business claimed to be normal for such years if not more than two years in the base period have been affected. If more than two years have been affected a detailed statement of normal conditions supporting the determination of average normal earnings must be submitted. Subsection (b)(2) would appear to cover not only cases of the complete loss of an important customer but also instances where the taxpayer lost a substantial amount of the business of such important customer due to the entrance of new competitors in the field. In such instances the taxpayer was often forced to attempt to develop new outlets for its product. Such a process takes time and subsection (b)(2) undoubtedly contemplates the granting of relief in such cases.

It is entirely possible that instances may arise in an industry where several competitors in their struggle for business undersell one another to such an extent that the effects of the practice may be substantially the same as those of a price war. There will undoubtedly be a twilight zone in which it will be very difficult to draw the line between normal competition and practices substantially equivalent to a price war.

In the case of the taxpayer which is required to develop new outlets for its business it would seem that the only recourse that the taxpayer would have would be to comparative statistics in the industry. It would seem reasonable to determine the sales of the affected years by taking the same proportion of the industry's sales in the affected years which the taxpayer's sales bear to the industry's sales in some subsequent year in which it has completely overcome the effects of the loss of its business with its principal customers. The new regulations approve this method.

In the case of taxpayers suffering from the effects of a price war or of such severe competition that it is substantially equivalent to a price war, it would appear that the normal earnings for the affected years could be determined by repricing the sales. The revised prices should be equal to those which could have been obtained had normal competitive conditions existed during the particular years.

Abnormality Due to Adverse Profits Cycle or Inadequate Representation of Sporadic Profits

Subsection (b)(3) provides relief particularly for taxpayers in the heavy goods industries or those in which the profits cycle is relatively long and where the base period reflects either no profits at all or profits of a very small amount. Form 991 requires a description of the industry and names and addresses of other members. The taxpayer is also required to furnish data showing that its business was depressed by reason of an unusual profits cycle. It appears advisable for such taxpayers to furnish a graph with Form 991, which would plot their net income and also that of their industry for a period of at least one cycle. The form requires the taxpayer to describe the period, if any, during which average profits are claimed to represent average normal earnings and to furnish reasons and particulars supporting its claim.

The new regulations state that a taxpayer claiming relief under this subsection must show that the business experience both of itself and the industry of which it is a member is susceptible of segregation into a cyclical pattern.

The form also provides that if a taxable period other than the base period is used in the computations, detailed computations and analysis of the period of not less than three years should also be submitted. Such period is required to bear the same relationship to the experience of the taxpayer as the base period bears to business in general. It is rather difficult to understand the meaning of such requirement as it is phrased on page 5 but the Senate Finance Committee report and the new regulations make it plain that the base period of the taxpayer must bear the same relationship to its cycle as the general business base period bears to the general business cycle. In other words, if the average of the amounts shown in the general business base period is 95 per cent of the average of the data included in the general business cycle, the taxpayer will be limited to 95 per cent of the average net income which it earned during its business cycle.

The Senate Finance Committee report and the new regulations state that it is impossible to define categorically a general business cycle,

and it is anticipated that there will be some difficulty in arriving at an agreement with the Commissioner as to the cycle to be used.

If the prior history of the taxpayer is not available, the new regulations state that recourse may be had to statistics of comparable taxpayers or industries for which the base period represents a period of normal earnings. However, relief will be denied unless the experience of the taxpayer is materially less than that of the general business cycle.

The second type of abnormality contemplated by section 722(b)(3) is the case where the sporadic periods of profits are inadequately represented in the base period. As in the case of the first type of abnormalities, it will be necessary for the taxpayer to compare its base period experience with the average of its experience over some representative period. If this ratio is less than that computed from comparable data taken from some general business cycle, the taxpayer should be permitted to use the general business ratio in the determination of its constructive average base period net income.

The new regulations endorse this method but require that the ratio shall be substantially less. The reduction in the ratio must be attributable to a depression which affected not only the taxpayer but also the industry of which the taxpayer is a member.

There are various statistical methods of determining averages and there is a wide variety of statistics relating to business in general and to specific industries. It is not feasible to attempt to recommend any particular method or any particular table. These must be selected and applied with due regard to the requirements in each particular case.

Commencement of or Change in Business Prior to or During the Base Period.

Section 722(b)(4) will probably prove to be extensively used. The phrase "change in the character of the business" includes (1) a change in the operation or management of the business, (2) a difference in the products or services furnished, (3) a difference in the capacity for production or operation, (4) a difference in the ratio of nonborrowed capital to total capital, and (5) the acquisition of all or part of the assets of a competitor. The change will qualify provided it occurred immediately prior to the commencement of the base period. The Senate Finance Committee report and the new regulations indicate that the change will qualify if the full effects thereof were not felt prior to the commencement of the base period. The change will qualify if it occurred after the base period as a result of a course of action to which the taxpayer was committed prior to January 1, 1940. In such event,

the change shall be deemed to have occurred on December 31, 1939.

If the full momentum of the change had not been reached by the end of the base period, the taxpayer should estimate the capacity it would have reached at that time, if the change had occurred two years before the actual date of the change. The statutory language is rather obscure but the Senate Finance Committee report and the new regulations make it plain that, in reconstructing the income for each of the base period years, it should be assumed that the taxpayer enjoyed the estimated capacity, not from the date of the change, but from the commencement of the base period.

The problem of estimating the enhanced capacity is by no means easy of solution. It is doubtful whether any comparative statistics would be available although they would be material if sufficiently similar. Furthermore, the period of time, unaffected by the war, within which the change developed is so short that, in most instances, it would be impracticable to determine a satisfactory rate of growth. The solution of such a problem must be left to the sound judgment of the management.

The new regulations provide that in determining growth, the taxpayer should consider, in addition to the factors mentioned in the preceding paragraph, its future prospects at the end of the base period. Unless the change occurred after December 31, 1939, pursuant to a course of action adopted prior thereto, no effect shall be given to events occurring thereafter.

In one case, a taxpayer engaged in the manufacture of kitchen units and in supplying parts to one of the three largest automobile manufacturers, moved its plant on September 1, 1938 and doubled its floor area and investment in machinery and equipment. The taxpayer claimed that 1940 represented the first year of full operations and determined its constructive volume of sales by multiplying the sales of the automobile company for each of the base period years by the ratio applicable to 1940. The constructive net income from the automotive department was computed by costing the additional volume and adjusting the operating expenses. The kitchen department which operated at a loss and which was not affected by the removal was left alone.

The examining agent claimed that 1939 should be used as the effective year and based his computations on the data of nine other suppliers, scattered all over the country and engaged in other lines of business. Having determined the constructive volume, he determined the net income by applying the actual net income percentages of the taxpayer without correcting them for the losses on the operation of the kitchen department or with-

out adjusting for fixed costs and fixed operating expenses. The taxpayer protested this adjustment and showed that 1939 did not reflect the full capacity of the taxpayer by indicating that the ratio of 1940 to 1939 volume in the case of the taxpayer was 2.23, in the case of the automobile manufacturer 1.35 and, in the case of the nine so-called automobile suppliers, after correction of certain errors in the revenue agent's report, 1.32.

This case is now pending before the conference section. It is important because it indicates that the Treasury is willing to use the comparative method of determining constructive volume. At least one case has been settled in the conference section of the Michigan District which involved the use of this method but the settlement is subject to post review in Washington. Most of the cases involving a material amount have gone to the Technical Staff.

The first abnormality referred to as a change was introduced by the 1942 Act and, according to the Senate Finance Committee report, was introduced to grant relief to those corporations which improved their earnings through the introduction of new processes of manufacture or new management methods. Examples are given of changes in sales and production methods and of a change from a system of hand loading to a system of mechanized loading. Another example is a change from door to door canvassing to direct sales to retailers. This provision should awaken enthusiasm in the most phlegmatic practitioner or controller. The possibilities of claims under this subsection are such that few taxpayers should assume that they are entitled to no relief. Many claims which were denied under section 722 prior to its amendment should be allowed under this subsection. For example, one claim was disallowed because the change could not qualify as a new product in spite of the fact that the improvements were so material that the taxpayer was granted a patent. The subsection seems broad enough to encompass any improvement in sales or production. New packages, new labels, new methods of selling may have effected an improvement in earnings. Changes in personnel, particularly executives and technicians in the factory of the manufacturer or in the laboratory of the technical processors of all kinds and descriptions frequently produce substantial increases in earnings.

The new regulations indicate that the Treasury will probably interpret this subsection quite narrowly. All improvements of a routine or usual nature are excluded from this subsection. The change must be substantial or drastic and must be productive of an increase in the level of earnings. Here again, a twilight zone will be encountered

and litigation will have to be resorted to for the purpose of evolving a more precise definition.

The second change, referred to in subdivision (4), is a difference in products or services furnished. The Treasury has been rather strict in the interpretation of the few cases that have been decided and limits the scope of the section to the introduction of new departments.

The third change relates to a difference in capacity for production or operation. There is usually no argument with the Treasury with respect to the existence of the abnormality. The variance of opinion arises in the determination of the amount of the relief. Most of the argument will probably revolve around the question of the selection of the proper comparatives. This method was employed under the old excess profits tax law and it will be recalled that after some litigation it was decided that the Commissioner was required to show the comparatives which were used in his determinations in proceedings before the Board of Tax Appeals. While no policy has apparently as yet been formulated by the Treasury with respect to this procedure, it seems reasonable to anticipate that the Commissioner will not refuse to show his hand under the present law. Incidentally, these comparatives will prove to be of inestimable value and the management of each taxpayer should not lightly refuse the request of other taxpayers for this data.

Where the change was completed after December 31, 1939, the taxpayer must show that it was committed to the course of action prior to that date. The commitment need not be of a legal nature but the evidence should show that certain definite steps were taken toward the consummation of the plan prior to December 31, 1939. The new regulations state that the commitment may be proved by a contract for the construction, purchase, or other acquisition of facilities resulting in such change, by the expenditure of money in the consummation of the desired change, by the institution of legal action looking toward such change or by any other change in position unequivocally establishing the intent to make the change and commitment to a course of action leading to such change. If the taxpayer can prove this, it is assumed that the change was effected on December 31, 1939. The taxpayer must then estimate the volume it would have reached on that date, if the program of expansion had been completed on December 31, 1939. Here again, the tax practitioner or controller will have to rely heavily on estimates made by the management.

Where taxpayers have instituted a program of civilian expansion prior to December 31, 1939 and have later engaged in war work their program has necessarily been

modified by the demands of their war contracts. The taxpayer should be entitled to the increased capacity arising from changes actually effected and traceable to plans drawn up prior to December 31, 1939. The actual determination of this factor is largely a question of judgment.

In preparing the evidence to be submitted in support of the claim that certain additions were made pursuant to a program of expansion adopted prior to December 31, 1939, the taxpayer must exercise care to avoid statements which are inconsistent with those made in the application for necessity certificates. It is possible that the taxpayer may in certain cases, without making misrepresentations, refer to the same addition in both Form 991 and the application for the necessity certificate, but it is improbable that the Treasury will permit the adoption of an inconsistent position. Both Form 991 and the application for the necessity certificate must be made under oath. In reviewing the statements made, the taxpayer should consider all representations made in correspondence which related to the granting of the application.

Where the change had not been completed by the close of December 31, 1939, it is clear that the operations for 1940 or 1941 would not reflect the complete effect of the expanded facilities. Form 991 very properly requires that, in computing the credit for those years, it be reduced proportionately to reflect the fact that the entire facilities as expanded were not productive of income during the entire year. Where the expansion has progressed throughout the year, the extent of the change required by the form could be determined from the rates of the average monthly production to the total production which could have been obtained had the total facilities been effective throughout the year. Form 991 also correctly provides that credit will not be allowed for additions to invested capital the proceeds from which were expended in carrying out the program of expansion.

The fourth change relates to a difference in the ratio of nonborrowed capital to total capital. Several cases have been allowed under this category. In those cases, the taxpayers sold additional stock or used their accumulated earnings to reduce their borrowed capital. The relief results in the addition to the base period earnings of the reduction in the interest. This procedure is approved in the new regulations. Where bonds in substantial amount have been recapitalized through the issuance of stock, the relief may amount to a material sum.

The fifth change relates to the acquisition before January 1, 1940 of all or part of the assets of a competitor with the result that competition was eliminated or di-

minished. This section should be considered in connection with Supplement A which applies when substantially all the assets were acquired in exchange for stock. In one case, the Treasury has allowed a claim based upon the acquisition of some of the assets of a competitor in 1938. The taxpayer only claimed correction for certain abnormal expenses incurred in the year in which the departments were merged. No claim was made or required with respect to the prior years although it appears that the Treasury might have required the adjustment since the taxpayer was enjoying the use of the growing income method.

Subsection 722(b)(5) is a catch-all section which relates to those abnormalities which do not precisely fit the definitions of the preceding subsections. Many cases will arise where a particular abnormality may approximate the requirements of another subsection. In such instances, the taxpayer should also make the claim alternatively under section 722(b)(5).

New Corporations

Section 722 (c) is designed to afford relief to those corporations which were not in existence, actually or constructively, prior to January 1, 1940.

The first subdivision relates to those cases in which intangible assets not includible in invested capital make important contributions to income. In order to obtain relief under this subdivision, it is not necessary to consider the character or the inadequacy of capital. The only requisite is that intangibles make important contributions to income and are excluded from invested capital.

Relief is probably intended for those cases where the new corporation is formed by persons possessing technical qualifications. Inventors may have worked on a group of patents during the base period years and may not have succeeded in obtaining the requisite capital until after the close of the base period. Another example would be the case of a group of people in the restaurant business who may have established an international reputation in France. If they should come to this country and incorporate after the base period, it would appear that they would be entitled to relief.

The most feasible method of determining the amount of the relief is to attempt to obtain the statistics of an established competitor and to substitute a proper proportion thereof. It seems, however, that comparative statistics will be rather difficult to obtain. In such instances, the only recourse will be to estimate the volume in the light of all the surrounding facts and circumstances. Form 991 requires that names of other comparative corporations be submitted. If the data from competitors cannot

be obtained, the Commissioner will probably test the estimates of the taxpayer by comparison with other taxpayers.

The second subdivision relates to those cases where capital is not an important income-producing factor. It is quite possible that the examples given under the preceding subdivision would also apply here. The Senate Finance Committee report gives the example of a corporation formed by a group of fashion consultants who employ a large technical and professional staff. It would seem that this subdivision would cover all corporations rendering specialized or professional services where some capital was necessary in the operation.

Taxpayers interested in this subdivision may find a review of the decisions handed down under section 209 of the 1917 Act profitable. That section provided special treatment for "a trade or business having no invested capital or not more than a nominal capital."

It would seem that any decisions holding that a taxpayer came within section 209 should be helpful because the requirements of the old law were more stringent than those of the new law.

The third subdivision relates to cases where the capital is abnormally low. It is suggested that taxpayers try to fit their claims in other subdivisions because the Treasury will probably argue that relief should be limited to treating part of the borrowed capital as equity capital.

From the foregoing, it appears that section 722 covers many types of abnormalities. Before deciding that the company is entitled to no relief, the section should be thoroughly discussed with the principal executives and the members of the sales and production departments. It is quite possible that they have certain recollections of abnormalities which may not be apparent from an analysis of available accounting data.

Implications of Recent Supreme Court Decisions on Stock Dividends

BY J. MARVIN HAYNES
(*Washington Office*)

In 1920 the U. S. Supreme Court, in a five to four decision in *Eisner* v. *Macomber*, 252 U. S. 189, held that a common stock dividend on common stock did not constitute income within the meaning of the Sixteenth Amendment to the Constitution. In 1942, the Government persuaded the Supreme Court to reconsider this question in three cases: *Helvering* v. *Griffiths*, 87 L ed 597; *Helvering* v. *Sprouse* and *Strassburger* v. *Commissioner*, 87 L ed 732. As these last two cases were disposed of on the basis of the *Griffiths* decision, no further reference will be made to them.

In the *Griffiths* case with three dissents the Court refused to overrule *Eisner* v. *Macomber*, saying in effect that, in writing subsequent tax laws, and in defining dividends which were taxable, Congress had adopted the principle enunciated by *Eisner* v. *Macomber*. However, the inference may be drawn from the Court's opinion that if Congress should impose a tax on stock dividends such a tax would be sustained by the present members of the Court and that the Court would overrule *Eisner* v. *Macomber*. In the majority opinion the Court seems to leave no doubt on this subject. In referring to the opinions of the Court in the cases of *Helvering* v. *Brunn*, 84 L ed 64, and *Helvering* v. *Horst*, 85 L ed 75, the Court said:

> Each of these decisions undermined further the original theoretical bases of the decision in *Eisner* v. *Macomber*.

In other words, the Court clearly says that in these two cases the basis on which *Eisner* v. *Macomber* was decided had been overruled. Further on in the opinion the Court said:

> There is no reason to doubt that this Court may fall into error as may other branches of the Government.

Such a statement obviously gives rise to the conclusion that if Congress should enact a tax on stock dividends it would be sustained. In the same paragraph the Court apparently invites the passage of such a tax when it says:

> Nothing in the history or attitude of this Court should give rise to legislative embarrassment if in the performance of its duty a legislative body feels impelled to enact laws which may require the Court to re-examine its previous judgments or doctrine. The Court differs, however, from other branches of the Government in its ability to extricate itself from error. It can reconsider a matter only when it is again properly brought before it in a case or controversy; and if the case requires, as a

tax case does, a statutory basis for a case, the new case must have sufficient statutory support.

Justice Douglas wrote a dissenting opinion, in which Justices Black and Murphy joined, holding that *Eisner* v. *Macomber* should be overruled and that under the 1936 Revenue Act Congress had authorized the taxation of stock dividends. As Justice Rutledge was not a member of the Court when the *Griffiths* case was argued he did not participate in the decision. It may be inferred from the *Griffiths* decision that eight members out of nine have said to Congress that if a tax is imposed upon stock dividends the Court will sustain such a tax under the Constitution.

The Treasury may request Congress to enact such a tax, and in that event it is anticipated that Congress might do so. The question is, to what extent would such a tax be made retroactive? It should not be made retroactive and should apply only to stock dividends declared and paid after imposition of such a tax. Congress might, however, take the position that corporations had a clear warning on March 1, 1943, the date of the *Griffiths* decision, and that stock dividends declared and paid after that date should be subjected to tax.

Should such a tax be imposed, it would not result so much in raising revenue as in stopping the further declaration of stock dividends, as corporations would presumably refrain from declaring stock dividends of the type involved in the cases considered in this article if they were to be subjected to the same rate of tax as cash dividends.

The *Griffiths* decision may also have far-reaching effects in other forms of taxation. The Government's brief devoted nine pages to a discussion of the importance of overruling *Eisner* v. *Macomber*. In its brief the Government said:

> The importance of overruling *Eisner* v. *Macomber* is not merely that the Government may be able to tax stock dividends, although many millions of dollars in taxes may be involved each year with respect to stock dividends. Of far greater importance is the removal of the restriction that it imposes upon the taxation of corporate earnings in the hands of the shareholders at the appropriate surtax levels.

Further on in its brief the Government said:

> Moreover, even if Congress should again prefer to tackle the problem in whole or in part through the undistributed-profits tax, *Eisner* v. *Macomber* stands in the way of a suitable statute. The 1936 undistributed-profits tax, as enacted, was the source of widespread dissatisfaction and irritation. There were countless complaints that corporations were being forced into making distributions of assets that were unsound from a business point of view, in order to avoid the rigors of the undistributed-profits tax. However, if *Eisner* v. *Macomber* did not block the way, stock dividends could be declared against the earnings in such manner that there would be no disturbance of the corporate structure.

(*Continued on page 31*)

The L. R. B. & M. Journal

Published by Lybrand, Ross Bros. & Montgomery, for free distribution to members and employees of the firm.

The purpose of this journal is to communicate to every member of the staff and office plans and accomplishments of the firm; to provide a medium for the exchange of suggestions and ideas for improvement; to encourage and maintain a proper spirit of cooperation and interest, and to help in the solution of common problems.

Current Tax Payment Act

The wartime program of federal income taxation was considerably accelerated by the 1942 Revenue Act with its greatly increased tax rates and with a greatly widened application of the rates applicable to individual incomes through marked reductions in personal exemptions. Congress has recognized, with belated concurrence by the Treasury, that this called for a drastic change in the method of collecting the individual income tax.

The need for doing so was accentuated by the fact that for the first time millions of taxpayers with relatively modest incomes are being subjected to tax thereon at substantial rates. Collection thereof would in such cases seem assured only if the tax is collected concurrently with the earning of the income.

The Ruml plan for placing income taxpayers, big and little, on a pay-as-you-go basis, which attracted so much attention both in and out of Congress for a year or more emphasized the importance of the subject.

The compromise which was resorted to in order to overcome the *impasse* in the Conference Committee of the Senate and House imposes an added burden on many

taxpayers by reason of requiring payment of more than one year's tax in each of the next two years (and in some cases even longer). This will be occasioned by the "unforgiven" 25 per cent of the 1942 tax (or of the 1943 tax, if that be smaller than the 1942 tax), as well as by the several anti-windfall provisions. In this respect the placing of taxpayers on a pay-as-you-go basis has produced a different result than contemplated by the Ruml plan.

The Current Tax Payment Act of 1943 is not the simple legislation which it might be thought possible to enact for the purpose to be accomplished. Hence, it has seemed desirable to present in this issue of the L. R. B. & M. JOURNAL an outline of the act and the manner in which its requirements are to be carried out.

Stock Dividend Decisions

(*Continued from page 29*)

Accordingly, a far more workable and satisfactory undistributed-profits tax could be achieved if *Eisner* v. *Macomber* were overruled. And particularly at this time, when the maximum revenues are needed by the Government and when it becomes of even greater importance that additional taxes be imposed as equitably as possible, neither the Treasury nor Congress should be strait-jacketed in the formulation of new legislation by an erroneous constitutional decision of sweeping dimensions.

In its brief the Government stated also that in the Civil War income tax law, corporate earnings were taxed directly to the stockholders, whether or not in fact the dividends were distributed to them, just as though they were members of a partnership.

In view of these statements in the Government's brief, it may be expected that the Treasury will again request Congress to enact an undistributed-profits tax or to tax the shareholders on the profits earned by corporations. With the unfavorable experience on the last undistributed-profits tax, there is considerable doubt whether Congress will reenact such a tax. While it might have been possible in the Civil War days to tax stockholders on the same basis as members of a partnership, Congress will no doubt find, with our present corporate set-up, widespread ownership of stock and frequent trading therein, that it will be an impossible task to tax stockholders on the same basis as partners are taxed. As a matter of fact, when the 1913 Act was passed Congress considered this problem, and in view of the complications that already existed at that time it was decided to be impracticable to tax stockholders on the same basis as partners.

If either of these two methods of taxation should be presented to Congress, it behooves taxpayers to impress upon their representatives in Congress the folly of attempting either form of taxation.

Notes

The following members of the L. R. B. & M. organization have joined the country's armed forces since the publication of the March issue of the JOURNAL:

Atlanta:
Stephen B. Ives
Robert A. Nichols

Baltimore:
Louis B. Peters
William E. Rooker

Boston:
Harry T. Wilson, Jr.

Chicago:
Edward M. Zolla

Cincinnati:
Thomas V. Borisch

Detroit:
Roland E. Smith

Los Angeles:
Irvin Sills
Lloyd F. Silvers, Jr.

New York:
Ralph N. Apple
J. Edward Burke
Charles D. Cavanaugh, Jr.
Francis E. H. Davies
Joseph W. Dodwell
Robert Kelley
Irwin E. Leibowitz
Arthur H. Medalie
Louis C. Moscarello

Philadelphia:
Leon Daniels
William P. McGann
Gino V. Zambelli

Pittsburgh:
Allen M. Johnson

Rockford:
Robert W. Fischer

St. Louis:
Harry G. Phipps

Mr. Lybrand, Mr. Bell and Mr. Staub attended the testimonial dinner which the friends of Mr. Samuel W. Reyburn had arranged in his honor for Friday evening, March 26, at the Hotel Pennsylvania. On February 1, Mr. Reyburn had retired from the chairmanship of the board of directors of the Associated Dry Goods Corporation which, together with its outstanding subsidiary, the Lord & Taylor store in New York, he had served for almost three decades.

The speeches by various friends and business associates of Mr. Reyburn were concise, and convincing in their sincerity, in paying tribute to his fine qualities of character and his business ability.

On April 14 and 15 the 1943 Dickinson Lectures were delivered at the Harvard Business School by Mr. Charles A. Heiss, who recently retired as comptroller of the American Telephone & Telegraph Company. His subject was "Accounting in the Administration of Large Business Enterprises."

Mr. Keller and Mr. Staub were among those who gathered at dinner in the Faculty Club on the evening of the 14th to do honor to the lecturer.

For lack of space, a number of notes are being carried over to the next issue.

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